(21)

SUPREME COURT OF THE UNITED STATES.

OCTOBER TERM, 1945.

No. 294.

SOUTHEASTERN BUILDING CORPORATION,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR WRIT OF CERTIORARI

**To the United States Circuit Court of Appeals,
Fifth Circuit.**

HAROLD C. ACKERT,
JOHN W. GIESECKE,
706 Chestnut Street,
St. Louis, Missouri,
Attorneys for Petitioner.

ACKERT, GIESECKE & WAUGH,
706 Chestnut Street,
St. Louis 1, Missouri,
Of Counsel.

St. Louis Law Printing Co., 415 North Eighth Street. CEntral 4477.

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To the United States Circuit Court of Appeals, Fifth Circuit.

To: the Honorable, the Chief Justice and the Associate Justices of the Supreme Court of the United States:

The petition of Southeastern Building Corporation respectfully shows to this Honorable Court:

A.

SUMMARY STATEMENT OF MATTER INVOLVED.

The cause herein was originally instituted by Southeastern Building Corporation by the filing with the Tax Court (then the United States Board of Tax Appeals) a petition in conventional form (R. 1). The cause subsequently

went to trial upon an amended petition (R. 5) wherein it was alleged that the Commissioner erred in including in the gross income of the Petitioner for the year 1939 the sum of $2,700 which he had denominated as "gain on retirement of bonds" and had further erred in allowing to the Petitioner depreciation in said year in the sum of only $3,291.90, whereas the Commissioner should have allowed depreciation including obsolescence in the sum of $9,436.97. The Commissioner, Respondent herein, in due course filed his amended answer to the amended petition (R. 18) denying in substance the errors alleged in the amended petition and setting up certain new matters not now pertinent in this proceeding. Thereafter, Petitioner herein filed its reply to the amended answer to amended petition (R. 26), being in substance a denial of the new matters alleged in Respondent's amended answer.

The cause came on for hearing before the Tax Court on May 14 and 15, 1943 (R. 3), at which time the parties presented their evidence, and thereafter and on or about February 29, 1944, the Tax Court made its findings of fact and rendered its opinion (R. 32-47). Subsequently, under date of May 18, 1944, the Tax Court entered its judgment and decision, pursuant to its Rule 50, wherein it found deficiencies in income and excess profits tax for the year 1939 in the amounts of $151.53 and $66.18, respectively.

The Tax Court by its decision sustained the Petitioner's contention that the Commissioner erred in including in gross income $2,700 as gain on the retirement of bonds, but sustained the Commissioner in his allowance of only $3,291.90 for depreciation instead of $9,436.97 as contended for by the taxpayer. An appeal to the United States Circuit Court of Appeals for the Fifth Circuit was duly taken by the Petitioner herein from the judgment of the Tax Court (R. 48). No appeal was taken by the Commissioner from that part of the finding and judgment of the Tax

Court which was adverse to him. The judgment of the Tax Court was affirmed (R. 77) in an opinion filed April 19, 1945 (R. 72-76).

In reaching the conclusion that the depreciation as allowed by the Commissioner was correct and that no additional allowance should be made for obsolescence the Court of Appeals held that, for the taxpayer to receive relief by way of an additional allowance for obsolescence, "he must show that the useful life of the property has been shortened and that the deduction for depreciation which covers ordinary wear and tear will not be sufficient to restore the cost of the property before its usefulness is at an end" (R. 75). As authority for its decision the Court cited and relied upon the **Revenue Act of 1926, section 234 (a) (7), 1944 Stat. 1942; Revenue Act of 1928, 23 (k), 26 U. S. C. A., section 23 (l)**, and **State Line and Sullivan R. Co. v. Phillips, 90 F. (2d) 652** (R. 15). The Court wholly ignored, failed to discuss, and failed to distinguish, apply or follow the prior authoritative decisions of this Court which this Petitioner had urged were applicable and controlling and in which cases this Court had allowed a deduction for obsolescence without any showing by the taxpayer that the useful life[1] of the property involved had been shortened. Moreover, this Court had further expressly held that obsolescence may arise from things which operate to cause the property to suffer diminution in value and hence had allowed obsolescence where the evidence had shown that the useful life of the property was not impaired, but only its "special purpose" life had suffered such impairment.

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1 The crux of the question is "what constitutes useful life?" The Tax Court and the Court of Appeals gave "useful life" a meaning practically synonymous with physical life. As so used there could never be such a thing as obsolescence of a building, for a building can theoretically always be used for some purpose so long as it has physical existence. Obviously "useful life" when used in reference to a "special purpose" building can contemplate only its "special purpose" life. Thereafter it ceases to exist as a "special purpose" building.

See also: Extensive quotation from Dewing, Financial Policy of Corporations, Appendix, infra, for a full discussion of the nature and proof of obsolescence.

The decisions of this Court just alluded to are **U. S. Cartridge Co. v. U. S., 284 U. S. 551, 76 Law. Ed. 431,** and **Burnet v. Niagara Falls Brewing Co., 282 U. S. 548, 75 Law. Ed. 594.**

The necessary effect of the decision of the Court of Appeals in this case is to disregard, violate and conflict with the principles announced by this Court in **U. S. Cartridge Co. v. U. S.**, supra, and **Burnet v. Niagara Falls Brewing Co., 282 U. S. 548, 75 Law. Ed. 594,** in that the Court of Appeals in this case placed upon the Petitioner the burden of furnishing proof that the useful (physical) life of the building in question had been shortened, whereas this Court, by its prior decisions in the above cited cases, had clearly held that the only conditions precedent to entitle a taxpayer to obsolescence for a "special purpose" building is to show that some event over which the taxpayer has no control has taken place which impairs its life as a "special purpose" building as distinguished from impairing its physical life. This Court in the **Cartridge Co. case,** supra, said "obsolescence may arise from * * * things which, apart from physical deterioration, operate to cause plant elements or the plant as a whole to suffer diminution in value." This Court also said, in **Burnet v. Niagara Falls Brewing Co.,** supra:

> "In determining the proper deduction for obsolescence there is to be taken into consideration the amount properly recoverable at the end of its service by putting the property to another use or by selling it as scrap or otherwise. There is no hard and fast rule, as suggested by the Government, that a taxpayer must show that his property will be scrapped or cease to be used and useable for any purpose before any allowance will be made for obsolescence."

B.

STATEMENTS DISCLOSING BASIS OF JURISDICTION.

(1) The original date of the judgment to be reversed is April 19, 1945 (R. 72). Petition for rehearing was filed May 5, 1945, within the time provided by the rules of the United States Circuit Court of Appeals (R. 78), and the petition for rehearing was denied May 15, 1945 (R. 81).

(2) The jurisdiction of this Court is based upon Judicial Code Section 240, as amended by the Act of February 13, 1925, 43 Stat. 938, U. S. C. A. Title 28, Section 347.

C.

QUESTIONS PRESENTED.

(1) Whether a taxpayer, owner of a "special purpose" building, upon the happening of an event over which the taxpayer has no control and which destroys its use as a "special purpose" building, is entitled to an allowance for obsolescence resulting therefrom, or whether the taxpayer must further show that the actual useful life of the building for all purposes, as distinguished from its "special purpose" life, has been shortened.

(2) In the interest of brevity **(Rule 38, para. 2; Furness, Withy Co., Ltd., v. Lange-Tsze Insurance Association, Ltd., 242 U. S. 430)**, Petitioner does not at this time set forth all of the questions which will be urged in the argument on the merits of this cause should the writ be granted, nor all of the contentions in support of such questions, but in order to comply with the rule of this Court requiring that all issues upon which a decision is requested be presented in the petition for certiorari **(Gunning v. Cooley, 281 U. S. 90, 98)**, Petitioner here refers to and incorporates into this petition all of the matters presented in its assign-

ments of error in its petition for review by the Fifth Circuit Court of Appeals (R. 52-53) with the same force and effect as if herein set out in full.

D.

REASON RELIED UPON FOR THE ALLOWANCE OF THE WRIT.

Because the Circuit Court of Appeals has made a clear-cut mistake of law of real importance and has decided an important question of the law of Federal taxation in conflict with the prior and applicable decisions of this Court in **U. S. Cartridge Co. v. U. S.**, supra, and **Burnet v. Niagara Falls Brewing Co.**, supra.

E.

Wherefore, it is respectfully submitted that the petition for writ of certiorari to review the judgment of the United States Circuit Court of Appeals for the Fifth Circuit herein applied for should be granted.

.....
HAROLD C. ACKERT,

.....
JOHN W. GIESECKE,
Attorneys for Petitioner.

ACKERT, GIESECKE & WAUGH,
Of Counsel.

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COMMISSIONER OF INTERNAL REVENUE,
Respondent.

BRIEF IN SUPPORT.

I.

THE OPINIONS OF THE COURTS BELOW.

The opinion of the Tax Court (Disney, J.) was promulgated February 29, 1944, and appears on record pages 32-47 (the opinion proper beginning on record page 38) and is reported in 3 T. C. 381. The opinion of the Circuit Court of Appeals for the Fifth Circuit (McCord, J.) was filed Aprii 19, 1945, and appears on record pages 72-76. It is reported in 148 F. (2d) 879.

II.

JURISDICTION.

The essential facts relative to the jurisdiction of this Court are fully stated in the accompanying petition for certiorari (supra, page 5) and in the interest of brevity are not repeated here.

III.

STATEMENT OF CASE.

Petitioner acquired the building in question, located in Atlanta, Georgia, on January 2, 1933 (R. 33), subject to a first mortgage then outstanding in the principal sum of $171,500.00 (R. 34) and subject also to a lease to Western Union Telegraph Company, a New York corporation, expiring December 31, 1943, and calling for a rental of $17,000.00 per year (R. 35). At the date of acquisition by Petitioner, Western Union was using the building as one of four similar warehouses in the United States (R. 36), and paid all rentals called for by the lease to Petitioner after January 2, 1933 (R. 35).

The building was erected upon a site especially chosen by Western Union (R. 56) and built according to plans and specifications required and approved by Western Union (R. 56). It was specially built to be occupied by Western Union as a storage warehouse and supply depot (R. 56), the first floor being built to carry almost unlimited loads and the second floor to carry from 200 to 250 pounds per square foot (R. 36), whereas the floors of a typical warehouse in Atlanta, Georgia, are built to carry only 125 pounds per square foot (R. 61). Consequently, the Tax Court found Petitioner's building "is built very substantially beyond the requirements of an ordinary storage warehouse" (R. 36).

Western Union vacated the building in July, 1934 (R. 36), but continued to pay the rent called for by the lease.

They sublet the building from February 1, 1935, to December 31, 1938, at an annual rent of $5,685.11, petitioner corporation assenting to the sublease on February 27, 1935 (R. 36). On December 14, 1938, Petitioner assented to a sublease for the year 1939 at $4,800.00 per annum (R. 36). On August 23, 1939, Petitioner assented to a sublease for a term beginning January 1, 1940, and ending concurrently with the original lease on December 31, 1943, at $6,000.00 per annum (R. 36). During all of these subleases Western Union continued to pay the $17,000.00 per year rental called for by its lease (R. 66), and there is no evidence it made any effort to avoid that lease.

Although 1939 taxes are at issue in this case, it was not tried before the Tax Court until May 14, 1943, and up to the time of trial the Petitioner had been unable to find a tenant who would use the building as a "special purpose" building and who would be willing to pay the higher rent which the building commanded as a "special purpose" building as distinguished from an ordinary warehouse (R. 37).

Under the foregoing facts the Tax Court held and the Circuit Court of Appeals affirmed that extraordinary obsolescence would not be allowed, as Petitioner had failed to prove that the physical life of the building had been shortened by the abandonment of its special use. The taxpayer, Petitioner herein, never contended and does not now contend that the physical life of the building or its useful life as a mere building was in any sense shortened by the event (abandonment of the lease by Western Union), but has maintained and here contends that such event definitely established that the building's "special purpose" life was shortened and terminated and gave rise to an allowable deduction for obsolescence.

IV.

SPECIFICATION OF ERRORS.

(1) The Circuit Court of Appeals erred in failing to allow as a deduction from Petitioner's gross income for the year 1939 the extraordinary obsolescence resulting from the abandonment by the tenant of the special use for which Petitioner's "special purpose" building had been built.

(2) The Circuit Court of Appeals erred in holding that extraordinary obsolescence will not be allowed unless taxpayer proves that the estimated physical life of the property has been cut short by the abandonment of its use for the "special purpose" for which it was built.

(3) The Circuit Court of Appeals erred in failing to hold that the abandonment of the use of Petitioner's building for the "special purpose" for which it was built resulted in a loss which was deductible as extraordinary obsolescence.

V.

ARGUMENT.

The decision of the Court of Appeals (as well as that of the Tax Court) is bottomed solely upon the proposition that the Petitioner failed to sustain the burden of proof required to entitle it to an allowance for extraordinary obsolescence solely because it had failed to "show the useful life of the property has been shortened" (R. 75).[1] Petitioner insists that under the prior decisions of this Court it is not required to carry any such burden of proof. This Court's decisions require only a showing of an unanticipated external event over which taxpayer has no control and which has caused the building as a whole to suffer diminution in value. Such showing is sufficient in itself, entirely apart from a showing of any shortened physical life, to entitle a taxpayer to a deduction for extraordinary obsolescence in computing Federal Income Tax.

The Petitioner herein respectfully insists that its position just above stated is expressly supported by two important decisions of this Court, **U. S. Cartridge Co. v. U. S., 284 U. S. 551, 76 Law. Ed. 431,** and **Burnet v. Niagara Falls Brewing Company, 282 U. S. 548, 75 Law. Ed. 594.** The decision of the Circuit Court of Appeals ignores and conflicts with the decisions just cited.

In **U. S. Cartridge Co. v. U. S.,** supra, the facts show that the Cartridge Company in 1914 built certain buildings for the "special purpose" of manufacturing ammunition for World War I. They were built on leased ground with the understanding that in 1924 (ten years later) they

[1] It may be noted that the Tax Court's holding on this point is inconsistent with its own prior decisions. Cf. **First National Bank of Mobile, 30 B. T. A. 632,** where it is stated "it is now generally known that the economic usefulness of office buildings is shorter than their physical life." **International Shoe Co., 38 B. T. A. 381,** where the Tax Court allowed an increased depreciation rate to cover obsolescence where the advent of high speed machinery made a multiple story factory less desirable despite the fact that the physical life of the building would remain unchanged, only its life for its "special purpose" as a shoe factory being affected.

would be turned over without cost to the owner of the land on which they were built. Thus, the buildings for taxpayer had a useful economic life of ten years, during which period the Cartridge Company could recapture their cost by depreciation deductions. The buildings were fully used for their "special purpose" until the Armistice in 1918. After the Armistice the company continued to use the property, though at no profit, until the lease ended on December 31, 1924. In other words, neither the physical nor the useful life of the buildings was cut short by the Armistice and the consequent abandonment of the "special purpose" for which they were leased; instead, as the Court said, the only result of such abandonment of special use was "a great diminution in value of the building in 1918." On such basis, this Court held the extraordinary obsolescence all occurred in 1918, when the Armistice and the reduced income from the property occurred, and announced the following rule for computing the resulting obsolescence **(76 L. Ed., l. c. 435)**:

> "The depreciated cost less the value of petitioner's right to use the buildings after 1918 must be taken into account for the proper determination of petitioner's 1918 income and profits tax."

This is precisely the point for which Petitioner in the case at bar is contending, for in this case the future loss of value resulting from abandonment in 1943 became definitely predictable at either one of three earlier dates.[2] The

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2 To-wit, July 1934, when Western Union closed the supply depot and moved out of the building; or in 1935, when the petitioner assented to the first sub-lease; or in August 1939, when petitioner first learned that Western Union had sub-let the building for the entire unexpired term of the lease.

The Court of Appeals found (R. 74) "the taxpayer was informed in July, 1934, that at the expiration of its lease agreement Western Union would not renew such lease." The petitioner does not agree with such finding, but a consideration of this point is not essential to a discussion of the issue presented by this petition for certiorari as the erroneous finding goes only to the question of the amount of the claimed deduction (which the Court of Appeals denied), whereas the petition herein asserts the right to a deduction for extraordinary obsolescence under the prior decisions of this Court.

deduction for extraordinary obsolescence can be taken whenever it is definitely predictable that the "special purpose" use will be abandoned, whether it be immediately upon the happening of an event or in the future.

The **Treasury Department Bulletin F (1942 Edition)** so concedes. At page 3 it is said:

> "Extraordinary or special obsolescence rarely can be predicted prior to its occurrence. However, this does not necessarily imply that the asset already must have been completely discarded or become useless, but merely that a point has been reached where it can be **definitely** predicted that its use for its present purpose will be discontinued at a certain future date. Deductions for obsolescence **of this type** may be taken over the period beginning with the time such obsolescence is apparent and ending with the time the property will become obsolete." [3]

The principle for which Petitioner contends was reaffirmed by this Court in **Burnet v. Niagara Falls Brewing Co., 282 U. S. 548, 75 L. Ed. 594.** The facts in that case are substantially identical with those in the case at bar. A brewery's property at the end of 1917 had a depreciated cost of $477,054.60, which, after deducting allowances in 1918 and 1919 for exhaustion, etc., was reduced to $279,-117.08. This Court said, **75 L. Ed., l. c. 596:**

> "But due to prohibition laws its actual value at the end of 1919 was only $90,475. That is $188,642.08 less than book value after such deductions."

After 1919 the company used only part of the building until 1921, when it ceased brewing. In 1922 the property was leased to others and in 1928 was still under lease at $5,000.00 per year. There was no proof in the case that the

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[3] Citation is substantially identical with Bulletin F (1931) applicable to the year here in issue. For further quotation from the same source, see: Appendix, infra.

physical or useful life of the building was shortened by the adoption of the Prohibition Amendment (which was the cause of the abandonment of the special use for which the building had been constructed). On the contrary, its economic and useful life continued (it was leased for other purposes) even though its "special purpose" life was terminated by the unpredictable event of prohibition. This Court allowed the taxpayer to deduct the extraordinary obsolescence resulting therefrom, to be apportioned between the two years 1918-1919, the period during which the brewery knew for certain that prohibition would become effective, and the time it actually occurred and the special use of the property was abandoned. There, as here, the property continued to be useful after such abandonment of its "special purpose" use, though for a different and less productive purpose.[4] This Court further held that there was no requirement on the taxpayer to show that the original estimated useful life of the property was cut short by the abandonment, **75 L. Ed., l. c. 598:**

> "In determining the proper deduction for obsolescence there is to be taken into consideration the amount probably recoverable, at the end of its service, **by putting the property to another use** or by selling it as scrap or otherwise. There is no hard and fast rule, as suggested by the Government, that a taxpayer must show that his property will be scrapped or cease to be used or useful for any purpose, before any allowance may be made for obsolescence."

There was no finding that the residual value of $90,475 should be depreciated over any shorter term than originally estimated, or that either the physical or useful life

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4 "A building used for manufacturing may become useful only as a warehouse. If this can be definitely shown to the satisfaction of the Commissioner, an allowance for obsolescence would be permissible, in addition to an allowance for depreciation. The useful life of the building may not be diminished, but the character of its use may be changed and thereby a substantial part of its value may be lost." G. E. Holmes, in **The Federal Income Tax, Columbia University Lectures** (1921), p. 152.

of the property had been shortened. Similarly, in the **Cartridge Company case**, supra, the taxpayer used the building for the entire period of its life, for its physical and economic life was not impaired by the ending of the war; only its "special purpose" life was terminated by the external event over which taxpayer had no control. The allowance of the extraordinary obsolescence in that case and in the **Brewery case**, supra, was in no way made dependent upon a showing of diminution of physical life.[5]

The decisions in the two cases above discussed directly refute the position taken by the Circuit Court of Appeals (and the Tax Court)[6] in the instanct case, which conditioned the taxpayer's right to an allowance for extraordinary obsolescence upon proof of a shortened physical life.[7]

In the case at bar there is no doubt that the loss in value resulted from the abandonment of the special use; the Tax Court so found (R. 37) and the real estate expert who testified specifically stated (R. 62) that his estimated residual value was predicated on the use of the property as an ordinary commercial warehouse rather than on the basis of its being used for the "special purpose" for which built. Nor can there be any doubt that the abandonment by Western Union was an event over which taxpayer could exercise no control.

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[5] For a complete discussion of questions of depreciation and obsolescence, see: Dewing (Appendix, infra), including analogous illustration, p. 27, infra.

[6] It may well be that the Court below fell into the same error to which the Court of Appeals of the Third Circuit called attention in the case of **Hazeltine Corporation v. Commissioner, 89 F. (2d) 513**, where it was said: "We think the Board may have fallen into this error through failing to draw a distinction between obsolescence and complete obsoleteness. It is of course true that the Neutrodyne Circuit continued capable after 1930 of performing, for those who still desired to use it, the same function in radio reception which it had theretofore and it may well be that a few persons did continue to use it after that time. This is far from saying that it was not 'obsolescent'."

[7] For criticism by a prominent Tax Service of the Tax Court's decision in the case at bar, see: **Alexander Tax News Letter, March 1944.**

Upon such facts extraordinary obsolescence should have been allowed,[8] because this Court in the **Cartridge Company case**, supra, specifically held:

> "Obsolescence may arise from * * * things which, **apart from physical** deterioration, operate to cause plant elements or the plant as a whole to suffer diminution in value." (Emphasis ours.)

The above statement of this Court is in irreconcilable conflict with the holding of the Court of Appeals in this case, which required a showing of a shortening of physical life as a condition precedent to allowing extraordinary obsolescence despite the abandonment of Petitioner's building for its "special purpose" use.

It is respectfully submitted that the writ of certiorari should be issued.

HAROLD C. ACKERT,
JOHN W. GIESECKE,
Attorneys for Petitioner.

ACKERT, GIESECKE & WAUGH,
Of Counsel.

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8 "Obsolescence . . . does not 'shorten' a property's useful life . . . this is because it is a question of value and not of physical wear and tear." **Saliers, Depreciation Principles and Applications (3rd Ed.).**

See also: Dewing, Appendix, infra.

APPENDIX.

Internal Revenue Code:

Sec. 23. Deductions From Gross Income.

In computing net income there shall be allowed as deductions:

* * * * * * *

(1) Depreciation.—A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence.

Treasury Regulation 103, promulgated under the Internal Revenue Code:

Sec. 19.23 (1)–6. Obsolescence.—With respect to physical property the whole or any portion of which is clearly shown by the taxpayer as being affected by economic conditions that will result in its being abandoned at a future date prior to the end of its normal useful life, so that depreciation deductions alone are insufficient to return the cost or other basis at the end of its economic term of usefulness, a reasonable deduction for obsolescence, in addition to depreciation, may be allowed in accordance with the facts obtaining with respect to each item of property concerning which a claim for obsolescence is made. No deduction for obsolescence will be permitted merely because, in the opinion of a taxpayer, the property may become obsolete at some later date. This allowance will be confined to such portion of the property on which obsolescence is definitely shown to be sustained and cannot be held applicable to an entire property unless all portions thereof are affected by the conditions to which obsolescence is found to be due.

Bulletin "F", revised January, 1942, issued by the Treasury Department, pp. 1-3:

Depreciation—Obsolescence—Definitions.

The Federal income tax in general is based upon net income of a specified period designated as the taxable year. The production of net income usually involves the use of capital assets which wear out, become exhausted, or are consumed in such use. The wearing out, exhaustion, or consumption usually is gradual, extending over a period of years. It is ordinarily called depreciation, and the period over which it extends is the normal useful life of the asset.

* * * * * * *

The factors of wear and tear and decay cause physical exhaustion, or deterioration, ultimately resulting in retirement of the property, while those retirements due to obsolescence are caused by forces ordinarily unrelated to physical condition.

Obsolescence may be defined as the process of becoming obsolete due to progress of the arts and sciences, changed economic conditions, legislation, or otherwise, which ultimately results in the retirement or other disposition of property. As said by the Supreme Court in United States Cartridge Co. v. United States (1932) (281 U. S. 511, 516, Ct. D. 460, C. B. XI-I, 282, 283 (1932)), "Obsolescence may arise from changes in the art, shifting of business centers, loss of trade, inadequacy, supersession, prohibitory laws and others things which, apart from physical deterioration, operate to cause plant elements or the plant as a whole to suffer diminution in value."

With respect to any property for which past experience indicates a gradual lessening of useful value due to inadequacy or obsolescence and when the effects of such factors can be expected to continue without substantial variation, the annual diminution in useful value is considered ordinary or normal obsolescence to be included in depreciation. Much of the discussion

hereinafter having specific reference to depreciation only is in fact equally applicable to normal obsolescence.

Some property, however, may become obsolete or inadequate due to revolutionary or radical changes unforeseen and unpredictable by their nature when the property was acquired. To distinguish from the allowance for what is considered normal obsolescence, this type is usually termed extraordinary or special obsolescence, allowances for which will be dealt with more specifically hereinafter.

* * * * * * *

Probable Useful Life—Rates of Depreciation and Obsolescence.

In general.—The amount of the annual deduction allowable for depreciation is ordinarily dependent upon the expected useful life of the asset. The factors which determine the useful life of property in a trade or business have already been discussed briefly in the Introduction. These factors are wear and tear and decay or decline from natural causes; and also various forms of obsolescence attributable to the normal progress of the art, economic changes, inventions, and inadequacy to the growing needs of the trade or business. Two principal forms or types of obsolescence are generally recognized, that is, normal obsolescence and extraordinary or special obsolescence.

Normal obsolescence is caused by factors which can be anticipated with substantially the same degree of accuracy as other ordinary depreciation factors, such as wear and tear, corrosion or decay. Accordingly, it is included in estimating the normal useful life of depreciable property, the effect of which is to include the allowance for normal obsolescence in the depreciation deduction.

Extraordinary or special obsolescence rarely can be predicted prior to its occurrence. However, this does not necessarily imply that the asset already must have been completely discarded or become useless, but

merely that a point has been reached where it can be definitely predicted that its use for its present purpose will be discontinued at a certain future date. Deductions for obsolescence of this type may be taken over the period beginning with the time such obsolescence is apparent and ending with the time the property will become obsolete.

EXCERPTS FROM "FINANCIAL POLICY OF CORPORATIONS" BY DEWING (FOURTH ED., VOL. I).

CHAPTER 3.

Obsolescence.[a]

The Maintenance of Capital in a Changing Economic World.—Great care has been exercised in the preceding chapter to confine our attention to depreciation—**the recovery of the original cost of the investment in permanent property of the business through regular allowances out of the gross earnings of the years during which the permanent property helps to provide the earnings.** But these charges are based on two assumptions—that the owners of the corporation desire to have their original investment returned to them in cash and that the economic conditions under which the earnings are produced do not change. Under the realistic conditions of modern corporate enterprise neither one of these assumptions is true. The proprietors of the business do not ordinarily want the return of their investment in the form of cash; they want the continuing earning power of their investment. This can be brought about only if the depreciation allowances are

[a] In an earlier edition of this book obsolescence was included as one of the elements of depreciation. Following certain traditions it was called functional depreciation.[1] Much reflection and the impact of some of the lessons of a long-continued depression have led me to change my mind. I now feel that the previous inclusion of obsolescence within the allowance for depreciation was wrong—wrong in theory, wrong in practice and wrong in the light of a complete and incisive disclosure to the corporations' stockholders. Like all converts, I feel this decisively and without reservation. Many of the things, observed during this depression, have strengthened my conviction. Not the least of these has been the realization that a great steel company—conspicuous since its organization for its frank and honest statements to its shareholders— could not have overstated its net earnings for upward of a decade by disregarded obsolescence had the company made annual allowance for obsolescence independent of the provision for depreciation.

[1] Edition of 1934, p. 519.

reinvested in new means of production. The economic conditions under which the business operates are not changeless, static; they suffer change continuously through inventions and advances in the arts and through fluctuating price levels which predetermine varying money-costs for new property. Since these conditions exist, the maintenance of the original investment is not achieved by merely writing off, through successive earning periods, the money cost of the original investment; it is achieved only if the wearing and the aging parts of the permanent property are gradually replaced by new equipment having an equal or greater earning power.

The presumption that depreciation allowances can adequately maintain the original investment assumes the operation of the business in a static economic world. **To insure its maintenance in a dynamic world a supplementary allowance or adjustment to earnings must be made which refers forward to the probable future costs of replacements and not backward to the original costs of the investment.**[b] This supplementary allowance takes full cognizance of a changing economic scene—inventions, new processes, new methods of distribution, new tastes of the consuming public. It also takes full cognizance of a changing level of prices which may necessitate the payment of higher money costs for equivalent replacements by producers' goods of the same earning capacity. This supplementary allowance set

[b] In a footnote Saliers states: "Much accounting literature, including the Treasury Regulations, infer that both depreciation and obsolescence may be operative at the same time. This is impossible, since one or the other is greater, and the greater can be the only effective cost." [2] Such a statement represents a complete misconception of obsolescence. Not only may depreciation and obsolescence operate together, but they invariably do operate together. They represent different costs arising from the effect of the passage of time on the permanent property of a going business. One is the cost of the using of capital already invested; the other is the cost of substituting for the aging capital improved and efficient replacements. And the earnings of the income period must bear both costs if the earning capacity of the capital invested in the business is to be kept intact.

2 Saliers, E. A., Depreciation (3d ed. 1939) 279.

aside to preserve the earning capacity of capital goods by means of adequate replacements is called obsolescence.[c]

The original investment was made for the primary purpose of making profits. The maintenance of the original investment is not the maintenance of either the physical totality of the property comprising this investment nor its value as evidenced by its earning capacity. **The maintenance of the original investment is the preservation of its earning power.** And to insure the maintenance of this earning power, there must be continuously, the replacement of obsolete and outmoded equipment by new and more efficient equipment; and the replacement costs of this improved and more efficient equipment is a burden, in addition to depreciation, which the continuing business must bear in order to hold its competitive position in the industry.

Due to the fact that replacements will occur probably before the age and use-life of the original investment have

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[c] Obsolescence has been variously defined. Perhaps the best single definition: **"Obsolescence is that which is brought about by the progress of the arts and sciences, changed economic conditions, legislation, or otherwise, whereby it can be predicted with reasonable accuracy that property used in the trade or business will be useless at a definite future date prior to the expiration of the normal useful life of the property."** [3] This is an excellent definition. But it is most unfortunate that, in spite of a clear understanding of the nature of obsolescence, the Internal Revenue Department considers obsolescence as a part of depreciation and not an independent and distinguishable charge against earnings.[4] The whole purpose of this chapter is—while accepting the meaning if not exactly the wording of the department's definition of obsolescence—to plead for a differentiation between depreciation and obsolescence. Much lazy thinking and many questionable practices among accountants have resulted from attempts to throw all charges against earnings into a single basket —and to call this basket depreciation. Saliers' well-known work on Depreciation is seriously affected by this attempt to merge obsolescence with depreciation.[5]

One engineer, considering depreciation and obsolescence from the point of view of utility rate valuation, hazards the opinion that the word "obsoleteness" more nearly fits the facts than does "obsolescence." [6] On the basis of its Latin origin, "obsolescence" implies a continuous process; the cause or causes underlying the decline in the use-value of physical property are discontinuous. This idea is better expressed by the word "obsoleteness."

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[3] United States Internal Revenue Bulletin — Income Tax Service (1931), Bull. F, p. 2.

[4] For discussion of Internal Revenue attitude toward obsolescence, see Saliers, op. cit. supra note 2, Ch. 19, p. 276.

[5] Id. at 48.

[6] Scharff, M. R., Depreciation of Public Utility Property (1941) 70.

been fully recovered through the allowances for depreciation, these supplementary allowances for obsolescence can be counted on to provide for the increased costs of the new equipment. These increases in cost may be due to the fact that more valuable and more costly equipment must be procured in order to enable the corporation to operate as cheaply and as efficiently as its competitors, or they may be due to a general rise in the price level of all commodities, or they may be due to a combination of these and other causes. The causes are, for the moment, ignored; the outstanding fact is simply this — the accumulations arising from the gradual writing off of the original capital are insufficient, even though they were kept in funds ready for investment, to buy such new equipment as the management deems necessary to maintain unimpaired the corporation's competitive position in the industry. These additional allowances, made necessary by advance in the arts or by a rising level of prices or by both, have absolutely nothing to do with the recovery, through earnings, of the original cost of the permanent property of the business. They are concerned with replacement. They are concerned with the new cost of the kind of equipment the management deems necessary to meet the technical conditions prevailing in the industry at the time the replacements are made.[d]

[d] It is quite common to acknowledge that depreciation and obsolescence represent charges against income due, in theory at least, to different causes. The whole purpose of this chapter is a plea for their separation in accounting practice.

Frequently, in financial statements, the charges against income are all lumped together as "depreciation"; sometimes the charges are called "depreciation, including obsolescence" as if the accountant condescended to do lip service to the distinction, without facing the obligation to discriminate between the two in practice. Frequently, too, the attempt is made by writers to include obsolescence with depreciation by calling it functional depreciation; [7] and it has been called "theoretical depreciation." [8]

[7] For example, Mason, P., Principles of Public-Utility Depreciation (1937) 2; Gilman, S., Accounting Concepts of Profits (1939) 499. Other writers on public utility accounting (L. R. Nash, for example) speak of functional depreciation as if they referred to obsolescence. The term is also used by the Interstate Commerce Commission, 180 I. C. C. 372 (1932); also Saliers, op. cit. supra note 2, at 46.

[8] Re Rates of the Public Service Gas Co. (N. J.), quoted Saliers, op. cit. supra note 2, at 50. See also Allison, J. E., In Re Theoretical Depreciation (1916) 29.

Importance of Obsolescence.—The importance of admitting possible obsolescence of equipment, due to the discovery of more improved, more efficient or more economical substitute equipment, is obvious to every business man

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This throwing of all charges against earnings into one category—and calling it depreciation—has high authority. The wording of decisions of the United States Supreme Court: "Broadly speaking, depreciation is the loss, not restored by current maintenance, which is due to all the factors causing the ultimate retirement of the property. These factors embrace wear and tear, decay, inadequacy, and obsolescence." [9] On the other hand, in one important case, a court ruled that a dividend was illegal and recoverable from the stockholders, to whom it had been paid, because obsolescence of an interurban railway had not been deducted from apparent earnings. Had this been done, no surplus would have remained from which to pay dividends.[10] And in a street railway rate case the commission, observing that ordinary depreciation allowance did not cover obsolescence, permitted a rate of earnings adequate to permit the allowance for obsolescence.[11]

This confusion between depreciation and obsolescence is quite general. The Interstate Commerce Commission in an order said: "Wear and tear, obsolescence, inadequacy, etc., are all factors in depreciation." [12] The findings of utility commissions, statutes and the writings of accountants all afford innumerable examples of attempts to include under the heading depreciation the recovery of the cost of physical equipment and the provision for the replacement of equipment with equivalent or improved earning power.[13] The accountant emphasizes the recovery of cost, calling it depreciation, although he lugs in obsolescence "as one of the factors"; [14] the engineer emphasizes the replacement of efficient equipment to maintain earning power, although he acknowledges cost as a basis or one of the bases on which equipment is to be valued; and the economist insists that depreciation, in order adequately to replace outmoded equipment, must acknowledge the changing purchasing power of money and, therefore, the changes in the money cost of replacements due to economic conditions beyond the perspective of a single business. Depreciation cannot cover all these factors. And the effort to bring under a single caption, to be called depreciation, allowances to care for all these costs is illogical. It is misleading.

The attempt, as in the Lindheimer case,[15] to make depreciation mean all these things, merely frustrates any serious effort to bring accounts—the actual dollars-and-cents allowances of depreciation—into conformity with the pronouncements of the Supreme Court. I am clear that many

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[9] Lindheimer v. Illinois Bell Tel. Co., 292 U. S. 151, at 167 (1934).

[10] Guaranty Trust Co. of N. Y. v. Grand Rapids, G. H. & M. Ry. Co., 7 F. Supp. 511 (1931).

[11] Milwaukee v. Milwaukee Electric Ry., 10 Wis. R. R. Comm. Rep. 1 (1912).

[12] Order dated July 28, 1931.

[13] The studies of the accountants and engineers of the American Telephone and Telegraph Company are among the most competent conducted under the auspices of a large industry. Yet in one important study, that of A. B. Crunden and D. R. Belcher, (1929) 8 Bell. Tel. Q. 259 (reprint, 23), obsolescence is merely one of the eleven causes of ordinary depreciation.

[14] The Accountants' Handbook (Paton, W. A., editor 1934) 579, lists seven "principal causes" for depreciation. One is obsolescence. Some of the others are specifically causes for obsolescence rather than causes for depreciation.

[15] For quotation, see supra note (d).

having any acquaintance with manufacturing processes. In a country like the United States, where methods of production undergo profound changes from generation to generation, it is a matter of ordinary empirical observation that **all kinds of productive machinery pass out of use before their actual physical life is closed.** And an acknowledgment of this fact is necessary to enable the business executive to preserve undiminished the earning power of his physical capital. In no other way can he produce his goods at costs as low as those of newer, competitive factories equipped with machinery of the more recent design. Consequently, in addition to the annual allowance necessary to recover the original cost of the permanent

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of the discrepancies in the literature dealing with so-called depreciation are due primarily to this confusion—in theory and in actual accounting procedure between the writing off of cost and the accumulation of the means to buy new, efficient replacements.

By no means all the accountants obscure the distinction between depreciation and obsolescence. Gilman [16] quotes an English periodical article as follows: "Depreciation is a direct and measureable charge against profits; . . . **obsolescence, on the other hand, is a sacrifice voluntarily or involuntarily incurred in an effort to maximise profits in the future.** The consequence of this distinction is that provision for the possibility of obsolescence ought to be made by withholding from distribution profits which have already been measured after the deduction of depreciation." [17] An American writer has said: "In recent years an attempt has been made in some instances definitely to separate depreciation and obsolescence. This tendency to separate these two sets of factors seems a logical and necessary one. . . . Depreciation is caused by the **use** of certain productive facilities in producing goods or services, **while obsolescence leads to the non-use of certain productive facilities.** The former implies the gradual **expiration** or consumption of productive power, while the latter implies the **abandonment of unused potential productive power.**" [18]

One of the most incisive statements concerning obsolescence I have met with is from the pen of an eminent practicing accountant: "Obsolescence is one of the commonest and most typical of those losses which, although uncertain as to amount and time of incidence, are so nearly inevitable in industry and so important that every conservative executive desires to provide for them as best he can by anticipatory reserves." [19] This expresses, in a single sentence, what I have tried to say in a chapter. It was written in 1938; and the author must have had vividly before him the long-continued failure of the U. S. Steel Corporation to provide adequately for obsolescence and the shock to investment confidence when this adjustment was finally acknowledged.

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16 Gilman, op. cit. supra note 7, at 499.

17 (Sept. 1938) Accountants' Digest 16.

18 Moyer, C. A., Economic Aspects of Fixed-Capital Obsolescence (Sept. 1939) 14 Acc. Rev. 285 and 286.

19 May, G. O., Uniformity in Accounting (1938) 17 Harv. Bus. Rev. 1.

property, a supplementary allowance should be set aside to meet the cost involved in purchasing efficient machinery before the old has served its full term of use. **Obsolescence is the allowance for decline in economic productivity—an allowance out of earnings to maintain economic productivity.**

Granting that a building cost $100,000, that it has a useful life of fifty years if kept in repair, and if the corporation deducted $2,000 a year from its net earnings to compensate for the physical depreciation of the building, the corporation would meet the condition of gradually recovering the original cost out of the annual earnings during the life of the building. But the building was originally built for no other purpose than assisting in the corporation's business. During the ten years since it was built, changes in methods of construction or of manufacturing technique have rendered it useless for the original purpose. To assume that the apparent earnings have suffered a loss of only $20,000 during this ten-year period since the building was erected is pure fiction. The sole value of the building was to assist in production, for which purpose it had an original value of $100,000; but after ten years it has merely a scrap value, because it no longer contributes to this end. Clearly **it is this "value for the business," or "value as an agency of production," that gauges its true economic value.** It is this economic value which the business executive should be able to deduce from the figures of the accountant even though the building is carried at cost. Hence, the mere physical property depreciation allowance should have been augmented during the ten years by additional and clearly described allowances to register the decline in value for the specific purpose of the business.

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Alternatives to the Obsolescence Charge.—If a specific and direct allowance, to provide for early replacements

out of earnings, is not made against the net income of each year, one or the other of two alternatives is possible. Either the depreciation allowance can be made so large as to provide a fund from which to pay for the replacement of obsolete equipment; or else, unmindful of the probable need for replacement of outmoded equipment, the management may make a single huge charge to the surplus when the day comes to pay for these replacements.[q]

The first alternative is merely an attempt to obscure the facts—it is an attempt to do by indirection, and inaccurately, what could better be accomplished openly and with reasoned care by recognizing the obsolescence charge as distinct and separable from the depreciation charge. The second alternative is a species of deceit. During a period of years the net earnings are represented to be larger than they would be were the proper deductions for obsolescence allowed. Consequntly, due to these larger annual net earnings a larger earned surplus is accumulated than would be the case were the proper obsolescence allowances de-

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[q] There are, of course, two other possibilities—(1) The capitalization of the cost of the new equipment on the presumption that the capital of the corporation has been increased. But this presumption is untrue. The essential motive for replacement is to maintain the fundamental earning power of the corporation. The new equipment added to accomplish this purpose is not new capital—it is merely an instrument of production to maintain, unimpaired, the earning power of the old capital originally purchased.[30] (2) The charging of the total cost of the replacement to the earnings of the single year. This is a procedure which a "Statement"—one of the numerous "statements" offered by accountants these last ten years—of the American Accounting Association seems to suggest.[31] But the losses arising from the declining use-value of the equipment have been going on for years past. Is it not stark misrepresentation to charge the whole cost of these years of declining value to the one income period in which the replacements actually occur? And it is childish to try to correct a completed mistake by attempting to reconstruct the earning statements of the preceding years—as if repairing the lock on the stable door will bring back the stolen horse.

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[30] For further discussion of capitalization of losses, due to obsolescence, see Saliers, op. cit. supra note 2, at 134; Fleck, L. H., The Incidence of Abandonment Losses (June 1926), 1 Acc. Rev. 48. This author believes that the cost of replacing outmoded equipment may be capitalized if the reason for the replacement is clearly and obviously economy of operation.

[31] A Tentative Statement of Accounting Principles, etc., Am. Acc. Ass'n Postulate No. 8 (June 1936), 11 Acc. Rev. 189.

ducted each year. And the stockholders, the creditors and the public are led to believe that the net earnings are greater than the rapidly declining production value of the equipment warrants. Then, suddenly, out of a clear sky, the obsolete equipment is replaced and the cost charged to the accumulated surplus. This is merely the continued overstatement of earnings, then the correction of the mistake after the misrepresentation has, over long years, favorably affected the credit of the company.[r]

[r] This is not theory; it has one rather startling illustration. During a period of roughly ten years, from 1925 to 1934, the United States Steel Corporation reported net earnings, averaging approximately fifty million dollars a year. These net earnings purported to represent net earnings after an adequate allowance for depreciation; and the depreciation allowance was represented to include an ample allowance for obsolescenc. Then suddenly, in 1935, the accountants charged the accumulated earned surplus account with an enormous loss of approximately **two hundred and seventy million dollars—over a quarter of a billion dollars.** This charge was necessitated—in the words of the corporation—by the developments in the **art and mechanics of steel making "which have operated to reduce the normally expected life of such facilities, and to changes in plant location based upon shifting markets and transportation facilities."** These causes are exactly what we mean in this chapter by obsolescence. They are not what the accountants for the Steel Corporation call depreciation. And it is an insult to the intelligence of the investing public for the executives of the largest industrial enterprise in this country to pretend that their engineers and accountants could not appreciate and measure, with approximate accuracy, these obsolescence losses while they were occurring—during the ten years and more while the earnings were being overstated by exactly the amount of the final charge to obsolescence.[32]

[32] This incident discussed at some length: Hosmer, W. A., The Effect of Direct Charges to Surplus on the Measurement of Income (March 1938), 13 Acc. Rev. 34. Referred to Gilman, op. cit. supra note 7, at 542.

INDEX

CITATIONS

664286—45

In the Supreme Court of the United States

OCTOBER TERM, 1945

No. 294

SOUTHEASTERN BUILDING CORPORATION, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The findings of fact and opinion of the Tax Court of the United States (R. 32–47) are reported in 3 T. C. 381. The opinion of the Circuit Court of Appeals (R. 72–76) is reported in 148 F. 2d 879.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on April 19, 1945, and the petition for rehearing was denied May 15, 1945. (R. 77, 81.) The petition for a writ of certiorari was filed on August 3, 1945. The jurisdiction of this Court is invoked under Section 240 (a) of the

Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether the taxpayer is entitled for the taxable year 1939 to a deduction for obsolescence under Section 23 (l) of the Internal Revenue Code, as amended by Section 121 (c) and (d) of the Revenue Act of 1942.

STATUTES AND REGULATIONS INVOLVED

Internal Revenue Code:

> SEC. 23. DEDUCTIONS FROM GROSS INCOME.
>
> In computing net income there shall be allowed as deductions:
>
> * * * * *
>
> (l) *Depreciation.*—A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence.
>
> * * * * *
>
> (26 U. S. C. 1940 ed., Sec. 23.)

Revenue Act of 1942, c. 619, 56 Stat. 798:

> SEC. 121. NON-TRADE OR NON-BUSINESS DEDUCTIONS.
>
> * * * * *
>
> (c) *Depreciation Deduction.*—The first sentence of section 23 (l) (relating to deduction for depreciation) is amended to read as follows:
>
> "A reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—

"(1) of property used in the trade or business, or

"(2) of property held for the production of income."

(d) *Taxable Years to Which Amendments Applicable.*—The amendments made by this section shall be applicable to taxable years beginning after December 31, 1938.

* * * * *

(26 U. S. C. 1940 ed., Supp. IV, sec. 23.)

Treasury Regulations 103, promulgated under the Internal Revenue Code:

SEC. 19.23 (l)–6. *Obsolescence.*—With respect to physical property the whole or any portion of which is clearly shown by the taxpayer as being affected by economic conditions that will result in its being abandoned at a future date prior to the end of its normal useful life, so that depreciation deductions alone are insufficient to return the cost or other basis at the end of its economic term of usefulness, a reasonable deduction for obsolescence, in addition to depreciation may be allowed in accordance with the facts obtaining with respect to each item of property concerning which a claim for obsolescence is made. No deduction for obsolescence will be permitted merely because, in the opinion of a taxpayer, the property may become obsolete at some later date. This allowance will be confined to such portion of the property on which obsolescence is definitely shown to be

sustained and cannot be held applicable to an entire property unless all portions thereof are affected by the conditions to which obsolescence is found to be due.

STATEMENT

The facts as found by the Tax Court may be summarized as follows (R. 33–38):

The taxpayer was incorporated under the laws of Georgia on December 10, 1932, and has its principal place of business in Atlanta, Georgia. (R. 33.)

On January 2, 1933, Bertelle G. Barbour conveyed a storage warehouse and the land on which it was situated to the taxpayer. This property had been leased to the Western Union Telegraph Company for a term of 20 years from January 1, 1924, to December 31, 1943. The total rental was $340,000, or $17,000 per annum. Subsequent to January 2, 1933, all rents were paid to the taxpayer. (R. 33–34, 35, 36.)

This warehouse was erected upon a site chosen by Western Union and according to plans and specifications which it approved. The building was one of four similar warehouses operated by that company in the United States, and is a two-story brick and concrete structure, 110 feet by 180 feet long, and covering about 38,500 square feet. Its basement is just large enough for a furnace and it has an elevator and sprinkler system. There is a loading platform outside the

building and facilities for the loading and unloading of trucks in front of the building. The first floor is built to carry almost unlimited loads, and the second floor will carry from 200 to 250 pounds to the square foot. It is built very substantially beyond the requirements of an ordinary storage warehouse. (R. 35–36.)

The building was occupied by Western Union from January 1, 1924, to July 1934, and was vacant from July, 1934, to January 1, 1935, but was then sublet by Western Union from February 1, 1935, to December 31, 1938, to Peaslee-Gaulbert Corporation, a Kentucky corporation. The taxpayer assented to this sublease on February 27, 1935. The total rent for this term of 47 months was $22,100 (or $5,685.11 per annum). On December 14, 1938, the taxpayer assented to a sublease by Western Union to Fulton County, Board of Public Welfare from January 1, 1939, to December 31, 1939, at the rental of $4,800 for the term. On August 23, 1939, the taxpayer assented to a sublease from Western Union to Harbor Plywood Corporation, a Delaware corporation, for a term of four years from January 1, 1940, to December 31, 1943, at a rental of $24,000 (or $6,000 per annum). The last sublease and the lease to Western Union expired simultaneously on December 31, 1943. (R. 36.)

Western Union did not intend to renew its lease or reoccupy the building upon the expiration of

its lease, since the operations which it had been performing in this building were discontinued in Atlanta and consolidated with operations of a similar nature in Brooklyn. This fact was known to the taxpayer in July, 1934. (R. 36–37.)

Since the expiration of the lease on December 31, 1943, the taxpayer has not been able to find a tenant for these premises who has need of such extraordinary warehouse facilities. (R. 37.)

The cost of the building depreciated to July 1, 1934, was $110,934.16; to January 1, 1939, $97,-184.87; to December 31, 1939, $93,892.97; to December 31, 1943, $80,725.32. The amount of depreciation allowed from July 1, 1934, to December 31, 1939, was $16,941.68; and from December 31, 1939, to December 31, 1943, $13,167.60. In 1939 the residual value, that is, the depreciated value of the building as an ordinary warehouse, was $54,000, and on December 31, 1943, such value had increased to $57,750. The fair rental value of this property as an ordinary warehouse was $6,000 in 1939; and $8,400 in 1943. (R. 37.)

The Tax Court held that the taxpayer was not entitled to any deduction on account of obsolescence for the taxable year 1939. (R. 41–47.) Accordingly it decided that there are deficiencies in income and excess profits taxes for 1939 in the amount of $151.53 and $66.18, respectively. (R. 47.)

The Circuit Court of Appeals affirmed the Tax Court's decision. (R. 76.)

ARGUMENT

This case does not present a conflict of decisions. It was correctly decided below, and does not call for further review.

Section 23 (l) of the Internal Revenue Code provides for "a reasonable allowance for obsolescence," and since 1924, Treasury Regulations[1] covering this and corresponding provisions of prior revenue statutes have continuously permitted a deduction for oblescence with respect to physical property only when (Section 19.23 (l)–6, Treasury Regulations 103, *supra*)—

> the whole or any portion of which is clearly shown by the taxpayer as being affected by economic conditions that will result in its being abandoned at a future date prior to the end of its normal useful life, so that depreciation deductions alone are insufficient to return the cost or other basis at the end of its economic term of usefulness, * * *.

These regulations should be regarded as controlling. See *Real Estate Title Co.* v. *United*

[1] For provisions corresponding to those in Section 19.23 (l)–6 of Treasury Regulations 103, here involved see Article 166 of Treasury Regulations 65 and 69, promulgated under the Revenue Acts of 1924 and 1926, respectively; Article 206 of Treasury Regulations 74 and 77, promulgated under the Revenue Acts of 1928 and 1932, respectively; Article 23 (l)–6 of Treasury Regulations 86, 94 and 101, promulgated under the Revenue Acts of 1934, 1936 and 1938, respectively; and Section 29.23 (l)–6 of Treasury Regulations 111, issued in 1943 under the Internal Revenue Code.

States, 309 U. S. 13, 15–16; see also, *Becker v. Anheuser-Busch, Inc.*, 120 F. 2d 403, 413 (C. C. A. 8th), and *Detroit & Windsor Ferry Co.* v. *Woolworth*, 115 F. 2d 795, 797 (C. C. A. 6th). As petitioner failed to meet the requirements of these provisions, the deduction was properly denied below.

Petitioner not only ignores the regulation but is also in error as to the reasons given by the Circuit Court of Appeals and the Tax Court for their decisions. Both courts not only held, as petitioner asserts, that it had failed to show that the useful life of the warehouse was shortened by Western Union's failure to renew the lease but it was also their holding that petitioner had failed to show that deductions for depreciation, previously allowed and to be allowed, would be insufficient to restore the cost of the warehouse. (R. 44–6, 75.) Thus, both the Circuit Court of Appeals and the Tax Court recognized the necessity of meeting the two requirements set forth in the above regulation and found that the petitioner had not sustained its burden as to either. The Tax Court treated the question here as one of fact. (R. 45.) But, whether so treated or as a question of mixed law and fact (*Becker* v. *Anheuser-Busch, Inc., supra*, p. 412), its decision should stand. The issue is largely a matter peculiarly within the province of the Tax Court; its ruling thereon is in accord with *Real Estate Title Co.* v.

United States, supra, and is supported by substantial evidence. Cf. *Dobson* v. *Commissioner,* 320 U. S. 489, 501–502, rehearing denied, 321 U. S. 231.

Petitioner asserts a conflict between this case and *U. S. Cartridge Co.* v. *United States,* 284 U. S. 511, and *Burnet* v. *Niagara Brewing Co.,* 282 U. S. 648. Both of those cases arose under the Revenue Act of 1918 and Article 161 of Treasury Regulations 45, which merely provided for a deduction for obsolescence. Thus, those cases did not involve or discuss the regulation which is applicable here and which was first issued in connection with the Revenue Act of 1924. However, it is clear from the reference to those cases in *Real Estate Title Co.* v. *United States, supra,* this Court did not consider the regulation to be in conflict with them and it is obviously not inconsistent with those decisions.

In *Burnet* v. *Niagara Brewing Co., supra,* it was held that the taxpayer, a brewery, was entitled to a deduction for obsolescence for 1918 and 1919 because of the advent of national prohibition on January 20, 1920. The evidence showed that it was known early in 1918 that prohibition would be put into effect; that the taxpayer completely abandoned parts of its brewery; that it could find no uses to which it could convert its buildings profitably; that after deducting the depreciation allowances for the taxable years, the book value

of the property was about three times the actual value; and that the company was dissolved in 1921. Thus, the useful economic life of the brewery was, for all practical purposes, brought to an end when prohibition went into effect and the deductions allowed for depreciation were wholly inadequate to cover the diminution in the brewery's value. Obviously, the circumstances of that case are very different from those here where the petitioner has failed to show that anything has occurred to shorten the useful life of its warehouse, and there has been no abandonment either of the building or of its so-called special purpose.

The facts in *U. S. Cartridge Co.* v. *United States, supra,* are also different. There obsolescence was allowed a taxpayer manufacturing ammunition because of the effect on its property of the cessation of World War I. To carry on this war-time business, the taxpayer had constructed buildings in 1914 on leased land under an agreement requiring it to surrender the buildings in 1924. Thus the physical life of the buildings, so far as the taxpayer was interested therein, continued to the end of 1924 but their useful or economic life, viewed also from its standpoint, lasted only until the end of the war when all orders for ammunition immediately ceased. Thereafter the taxpayer tried to operate, but such operations were small and unprofitable; its buildings could not be rented; and its attempt to man-

ufacture other articles resulted in a loss each year. Clearly, the cessation of the war suddenly brought the useful life of its property to an end, and the depreciation deductions were also wholly inadequate to recover the cost thereof. But we do not have a comparable situation here. The petitioner's building was constructed for a warehouse and nothing has occurred to prevent it from being used for such purpose; it was so used throughout the period of Western Union's lease and later. While the findings indicate that since the expiration of that lease on December 31, 1943, the petitioner has been unable to find a tenant for the premises who has need of such extraordinary warehouse facilities (R. 37), nevertheless since that time the property has been rented as a warehouse (R. 61). Furthermore, the Tax Court found that the fair rental value of this property as an ordinary warehouse was $8,400 in 1943 which was more than 10% of its depreciated cost in that year. (R. 37.) Obviously the useful economic life of the warehouse has not been cut short and, as the Tax Court further found (R. 46), there has been no abandonment of the purpose for which it was built. Even if the property had been left vacant "more than non-use or disuse is necessary to establish" obsolescence. *Real Estate Title Co.* v. *United States, supra,* p. 16. See also, *Detroit & Windsor Ferry Co.* v. *Woodworth, supra.*

Petitioner, nevertheless, contends that obsolescence [2] should be allowed here because the failure of Western Union to renew its lease in 1943 resulted in a diminution of the value of its warehouse. However, the record not only fails to show that the alleged diminution has shortened the economic useful life of the warehouse, but there is also no evidence indicating that such diminution occurred in the taxable year 1939 nor the extent thereof, if any. The value of the warehouse was estimated as being less than its depreciated cost in that year but that may have been true for many years prior thereto. In addition such value has increased subsequent to that date since the record shows that it was higher in 1943 than in 1939. (R. 37, 62.) There is no showing that the cost of the warehouse will not be completely recovered through allowable deductions for depreciation. Thus, it is clear that there is no basis for obsolescence here.

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[2] Petitioner refers to "extraordinary obsolescence" and indicated, in the court below, that such obsolescence is not covered by the regulation here. (R. 13.) In that connection it cites Bulletin "F", Bureau of Internal Revenue, Income Tax, Depreciation and Obsolescence, Estimated Useful Lives and Depreciation Rates (Revised January, 1942), but that bulletin neither amends nor affects the regulation. Instead, it merely explains that the Treasury Department includes normal obsolescence in its computation of a deduction for depreciation. Thus, deductions allowed as "obsolescence" are for what is usually classified as "extraordinary obsolescence." See Section 23.105, 4 Mertens, Law of Federal Income Taxation.

CONCLUSION

The decisions below are correct. There is no conflict. The petition for certiorari should be denied.

Respectfully submitted,

HAROLD JUDSON,
Acting Solicitor General.
SAMUEL O. CLARK, JR.,
Assistant Attorney General.
SEWALL KEY,
ROBERT N. ANDERSON,
LOUISE FOSTER,
Special Assistants to the Attorney General.

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SUPREME COURT OF THE UNITED STATES.

OCTOBER TERM, 1945.

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Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITIONER'S REPLY TO RESPONDENT'S BRIEF IN OPPOSITION.

HAROLD C. ACKERT,
JOHN W. GIESECKE,
706 Chestnut Street,
St. Louis, Missouri,
Attorneys for Petitioner.

ACKERT, GIESECKE & WAUGH,
706 Chestnut Street,
St. Louis, Missouri,
Of Counsel.

ST. LOUIS LAW PRINTING CO., 415 North Eighth Street. CEntral 4477.

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PETITIONER'S REPLY TO RESPONDENT'S BRIEF IN OPPOSITION.

I.

Petitioner in its brief in support of its Petition for Certiorari has heretofore fully discussed its position herein and believes that it has demonstrated the conflict between the decision below and the prior decisions of this Court in Burnet v. Niagara Falls Brewing Co., 282 U. S. 548, 75 L. Ed. 594, and U. S. Cartridge Co. v. U. S., 284 U. S. 551, 76 L. Ed. 431. It therefore does not feel called upon to further comment thereon. However, Respondent's brief in opposition contains certain palpably erroneous statements which Petitioner feels must be pointed out and challenged by this reply.

II.

Respondent twice misstates the established fact of abandonment of the "special purpose" use of the Petitioner's building. On page 10 of its brief Respondent says "there has been no abandonment . . . of its so-called special purpose." Again on page 11 it is stated "there has been no abandonment of the purpose for which it was built."

Such statements are absurd. The Tax Court specifically found to the contrary (R. pp. 36, 37). The Tax Court merely found that the building, **as such**, as distinguished from its "special purpose" use, had not been abandoned.

III.

On page 11 of its brief Respondent states, "The Petitioner's building was constructed as a warehouse." This statement patently ignores the record facts that the building was not built **merely** as a warehouse, but as one of four similar "special purpose" buildings in the United States constructed especially for the needs of and to the exact specifications of Western Union at a location demanded by them (R. pp. 36, 56, 61).

IV.

Respondent's arguments in opposition all flow from a basic premise founded upon the misstatements of fact referred to in II and III, supra. Any force which such argument might otherwise have completely dissolves when considered in light of the true facts.

V.

Respondent says (Res. Brief, p. 8) that "petitioner has failed to show that deductions for depreciation, previously allowed and to be allowed, would be insufficient to restore the cost of the warehouse." Here again there is a failure

to distinguish between the status of Petitioner's building as a "special purpose" Western Union building and as a **mere** warehouse. Such distinction must be recognized or the realities of the situation discarded. The building's "special purpose" use ended with the failure to renew the lease and the depreciation allowed up to that time was insufficient to restore the cost of the "special purpose" features of the building.

Upon loss of "special purpose" use obsolescence arose as to this building just as surely as it did in the cases of the brewery or the cartridge manufacturer in the decisions of this Court relied upon. The fact that the brewery and the cartridge plant might have been subsequently used for warehouses or for the manufacture of soft drinks did not prevent the allowance for obsolescence being immediately made in those cases. Parts of the brewery and the cartridge plant were undoubtedly built for warehouses, but they would be brewery or cartridge warehouses, not just ordinary warehouses, and when their value as brewery or cartridge warehouses disappeared obsolescence arose, even though the entire cost would have ultimately been recovered through the depreciation allowances that would continue to be made during their useful lives as **mere** buildings or warehouses.

In the case at bar the loss of the "special purpose" use of Petitioner's building was dramatically demonstrated by the drastic drop in rental value.

VI.

Respondent asserts (Res. Brief, p. 8) that "Petitioner . . . ignores the regulation [Reg. 103, Sec. 19.23 (l)-6]." This is a strange contention in light of the fact that Petitioner set out the Regulation in the Appendix to its original brief (Pet., p. 17). However, a paraphrase of the Regulation will clearly show its application to the Petitioner's contentions herein. Such paraphrase would

read as follows: "The whole or the special pu in its which is clearly shown by the taxpayer as ha prior affected by the failure to renew the lease will re e, so special purpose use being abandoned at a future eturn to the end of its normal or special purpose user pose that depreciation deductions alone are insufficien the cost or other basis at the end of its speci term of usefulness."

VII.

The writ should issue.

Respectfully submitted,

HAROLD C. ACKERT,
JOHN W. GIESECKE,
706 Chestnut Street,
St. Louis, Missouri er.
Attorneys for P

ACKERT, GIESECKE & WAUGH,
706 Chestnut Street,
St. Louis, Missouri,
Of Counsel.